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PROGRESS IN ACCOUNTING

ADDRESS

of

William W. Werntz

Chief Accountant, Securities and Exchange Commission

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The problems with which professional accountants must inevitably concern themselves fall quite readily into four major categories. There are, first, the questions about what we sometimes call principles of accounting. Second, there are the problems involved in portraying the results of the accounting process, problems as to what are variously called principles of display or of preparing financial statements, or of disclosure. Third, there are the many problems of auditing, of how far to delve into the raw data and how far to go in describing the work done. Fourth, and finally, there are the relations of the accountant with his fellow accountants and with those he serves--the ethics of a profession.

The progress made in improving the character and significance of the services offered by accountants in largely dependent on the progress made with respect to these problems. Responsibility for their adequate and proper solution rests particularly with accountants themselves. It weighs as heavily upon the teacher as upon the practitioner; as heavily upon the accountant who would serve well the needs of small communities as upon the accountant who numbers the largest corporations among his clients; and as heavily upon the private accountant as upon the accountant in government service. It is my intention this morning to comment upon the important progress made in recent months and to consider briefly some of its implications.

ACCOUNTING

In the field of accounting principles, continued and even increasing attention has been given to authoritative expressions of the fundamental concepts by which accountants are guided. The possibility of formulating such statements was the subject of much study and much writing a few years ago. Now, concrete results are appearing. The difficulties are well recognized and great. The formulation of propositions possessing wide applicability is hampered by the variety and complexity of the business events with which accounting is concerned. Furthermore, the evolution of accounting, until recently, has been heavily, indeed too heavily, pragmatic, producing a structure with internal inconsistencies which have, nevertheless, been firmly cemented in place through long usage. Finally, there is frequent evidence of conflict between accounting principles and statutory provisions.

In spite of these difficulties the past year has seen an important contribution in the recent revision by the Executive Committee of the American Accounting Association of its statement of *Accounting Principles Underlying Corporate Financial Statements.*[1] This statement, with its exposition of the principles of cost, revenue, income and capital, represents a consistent and clear expression of accounting fundamentals. Lack of complete agreement with all of the applications given to these four basic principles need not diminish their significance. Indeed, the statement does not purport to solve the many varied and highly specific problems of everyday practice but attempts instead only to set forth criteria by which the propriety of solutions of specific questions may be measured. Crystallization of opinion with respect to a particular problem should imply general

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[1] 16 Accounting Review 133.

acceptance of some underlying considerations. Formal expression of these basic considerations provides a logical means of integrating the development of accounting thought.

This Institute, in its research program, has an objective at one with that of the American Accounting Association--the improvement of accounting--but has approached the problem b dealing directly with more or less specific problems. Such activity is of first rank importance and the statements on accounting principles contained in the research bulletins have been significant contributions. Of nearly equal significance is the raising of problems for discussion by means of tentative statements published in the Journal. It may be hoped that the flow of both kinds of statements and the discussion they engender will rise rather than subside.

The formulation of substantive accounting rules continues, however, to be fraught with many difficulties. Of these many obstacles, that which I would like to emphasize today is the apparent conflict of some accounting principles with certain statutory provisions.

The argument is not infrequently made that a particular accounting treatment is sound, or, at least, unobjectionable "because the law permits it." Such reasoning most frequently appears in connection with transactions or adjustments affecting the proprietary accounts on the balance sheet and is found in particularly clear form when a corporation, with legal sanction, seeks to declare a regular dividend from paid-in-surplus in spite of the existence of an earned surplus. Most accountants would feel, I think, that earned surplus ought to be exhausted before dividends are paid from capital sources since it seems an anomaly if a corporation might return capital while leaving earnings invested. One may even question whether a distribution of contributed capital can properly be called a "dividend" as that term is commonly understood.

I wonder, however, if the ultimate answer to this conflict is not that the objectives of statutes and of accounting, in this regard, are fundamentally different. No one will dispute the arguments that may be advanced in favor of distributions from paid-in surplus under some circumstances, as when earnings do not exist but the company has funds not needed in the conduct of its business. No sound argument can be developed to prohibit such payments. In fact, it is probably not an accounting problem at all. Where both earned and capital surplus exist, the distinction between them and hence the source of the distribution may, from the viewpoint of the statute, be immaterial. But is this equally true in accounting which, unlike the statute, has set up a distinction between the two sources?

After all, should not the statute be viewed as a regulative device with a protective purpose, designed to limit the discretion of management in its use and disposition of

corporate assets; that is, the statute controls the extent to which directors may return assets to stockholders without interference from creditors or other stockholders,[2] and is not necessarily designed to lay down a set of rules for determining whether the corporate activities have been in fact profitable? Although accounting must reflect the "legal effect" of corporate actions on the proprietary accounts, it is also a fundamental objective of accounting to determine whether a corporation is economically profitable. If the objectives of law and accounting are thus different, is there any reason why the concepts of either should be forced into a mold fashioned from the concepts of the other? It is perhaps because of efforts to synchronize these incompatible objectives that corporate balance sheets of today quite often reflect neither the amount legally distributable nor the residual amount of profits.[3]

It might solve much in this field if this difference in objectives were frankly recognized, and the entire proprietorship section customarily recorded in a double form--perhaps preferably as a separate statement coordinate with the balance sheet and income statement. In one column could be shown the amounts legally distributable by action of the directors, if counsel can agree on the amounts; in another column there could be shown the highly significant business fact, that is, the economic results of corporate utilization of the stockholder's investment showing separately, for example, aggregate investments, withdrawals, profits and distributions. Such divorcing of these conflicting viewpoints would free accounting from many unfortunate twists brought about by the ingenuity of the draftsmen of corporation laws. Furthermore, while corporation statutes would doubtless continue to employ accounting terms such as earned and capital surplus, these terms would become finer, more precise tools with which to achieve the intent of the legislative body.

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[2] Even requirements of disclosure when dividends are declared from paid-in surplus are by no means universal. Where specific permission is given to utilize paid-in surplus for dividends, is it not even arguable that such surplus may be so used only after earned surplus is exhausted?

[3] A situation not materially different sometimes arises in cases where the directors or a corporation are specifically empowered by statute to accomplish the equivalent of a quasi-reorganization without securing previous stockholder consent. Their action is quite legal but this does not necessarily dispose of the accountants' concept of earned surplus which connotes earnings since inception. Any disruption of the continuity of earned surplus seems to me sufficiently important from an accounting point of view to require, as a matter of accounting principle, the assent of the stockholders, and in the absence of such assent the accountant should be bound by accounting concepts and obliged to report both the legal and accounting effects of the adjustment. In a recent accounting opinion we have indicated our views as to the prerequisites of a quasi-reorganization and in an earlier release outlined the disclosures to be made when stockholder approval was not obtained.

The somewhat similar proposition that stockholder approval may single out and validate an otherwise objectionable accounting practice is not to my mind tenable.[4] I cannot believe that even the language of a corporate charter, to say nothing of a stockholder's vote, can make proper the charging of annual depreciation against capital surplus or the computing of profits without allowance for depreciation.[5] While, so far as the organizers or those who voted are concerned, one may not be in a position to object, yet when the financial record is to be placed before others as a basis for action, common principles ought to be observed. As in the case of differences between accounting principles and statutory provisions, so here, it seems to me a primary duty of accountants to reflect the application of sound accounting principles, disclosing as well the nature and results of stockholder action.

More than any other, perhaps, this field of the relation of accounting to law deserves careful study and promises fruitful results. There can be no denial that in wide areas accounting analysis is subordinate to and controlled by legal standards. But in other fields, particularly where the law is permissive and not mandatory, accounting principles and presentation should be independent of the legal interpretation and it is no answer to say the statute permits it or does not forbid it.

DISPLAY

Progress made in clarifying the basic principles of accounting has been more than matched by improvement of the standards or principles of disclosure. An oversimplified balance sheet, a three-figure income statement, the statement that "tells all" in an undigested mass of footnotes are becoming rarer. It seems quite clear that the investor of today has available on the average more complete, more accurate, and more informative financial data than ever before. Moreover, to a constantly increasing degree, the financial statements included in annual reports to stockholders tend to conform to the standards of

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4 This would not, of course, preclude a choice by stockholders in those areas where alternative and equally acceptable methods exist.

5 In the past year several cases have arisen in which questionable accounting treatments have been authorized by vote of the stockholders. There was one company, in particular, with along history of stockholder-approved departures from generally accepted practices. Some years ago this concern effected a reduction of the stated capital of both common and preferred stock and used the resulting capital surplus to absorb write-downs that ordinarily would have been charged to earned surplus. Later balance sheets did not reflect this detouring of earned surplus charges which, if properly applied, would have produced an earnings deficit. At the same time the directors of the corporation were given a continuing power to use the residual capital surplus, or any later acquired capital surplus, to absorb such charges as they might determine not to assign to income or earned surplus. Under these provisions the determination of the earnings and earned surplus to be reported by the company seems to me divorced from accounting requirements and left to the caprice of the directorate.

disclosure applicable to statements filed under the Securities Acts. Indeed, such conformity is mandatory under the Investment Company Act of 1940.

Without laboring the point, which has received extended consideration from all sides, it may be well to observe that financial statements out to be accurate, reasonably detailed, and intelligible. They should be accurate, not in the sense of portraying "the one truth," but in the sense in which any accounting statement presents a limited set of facts abstracted from a kaleidoscopic environment. They should be detailed in the sense that sufficient facts are reported to reveal the important relationships and trends. Of significance here is the fairly recent opinion in the matter of the American Sumatra Tobacco Company, since it contains a rather full statement of the Commission's views as to the minimum detail essential to an adequate income statement and examines at some length the arguments which have been pressed against furnishing more informative profit and loss statements.

Finally, financial statements should be intelligible in the sense that the descriptions given and format of presentation should facilitate rather than hamper understanding. It is important to note that the ultimate test of clarity lies not in the effect produced on the trained mind of the professional accountant who prepares or examines the statement but rather in the effect produced on the mind of the reader to whom it is directed, be he business man, lawyer, or layman. Educational efforts in this direction have resulted in the publication by the Institute of pamphlets describing in simple language the functions of accountants and the meaning of financial statements. One research bulletin has voiced approval of such a combined presentation of income and surplus statements as should enable the reader to grasp their over-all significance irrespective of the allocation of items between them. The American Accounting Association has also sought to resolve the latter problem by recommending that all charges and credits for expenses, losses and profits be routed through the income account.

Another effort to secure better understanding of financial statements is found in the two bulletins of the Institute dealing with accounting terminology. Perhaps the initial difficulty that confronts the average person in his contemplation of a set of financial statements is that of comprehending the basic accounting terminology necessarily employed. Here one is confronted with a dilemma. Popular usage is not precise. Yet on the other hand statements are for general consumption and, as I see it, cannot wholly disregard the connotations popularly attaching to many words. It seems to me, moreover, that the difficulty of finding an appropriate expression hardly warrants the expedient of redefining a term so that it can be used to suit our peculiar accounting needs. Such a solution if widely adopted would tend to heighten rather than dispel bewilderment.

For example, the term "liability" because of its customary meaning as a debt or obligation due and payable at some determinable future date, does not seem the most fortunate description for every account that appears on the right-hand side of the balance sheet. I doubt whether it contributes to understanding to characterize surplus, and particularly earned surplus, as a liability. If we have as our objective the presentation of

the clearest financial statements we can devise there seems little to recommend a more or less arbitrary definition of the terms we want to use. If the practice of accountancy were a science only of direct concern to those initiated into its mysteries, little objection could be raised to such definitions. However, the widespread use of accounting reports demands that appropriate recognition be given to the common meaning of words. It is not to be implied that any reconsideration of terminology will result in making accounting statements perfectly transparent to all readers. We can, however, do something to render them less opaque by using terminology less ambiguous to the reader.

AUDITING

The third major category of problems centers around auditing, the process by which the auditor prepares himself to express his professional opinion. The presence of a certificate, the fact that the statements are certified, these form the boundary that perhaps distinguishes the results of the private practice of accounting from its public practice. The absence of a certificate indicates that only the management, however competent, expert and well advised, has accepted responsibility for what the statements portray. The presence of an unqualified certificate adds to this the concurrence of independent, impartial experts after careful review and substantiation of the salient facts.

It is a little difficult to separate the progress of the past year from that of the last two or three years. The earlier period contained the shock of a celebrated case, wildfire discussion, myriad proposals, and countless panaceas. It contained, too, a good deal of sober reflection and self searching, both privately and in professional gatherings. It saw the adoption of professional resolutions designed to broaden the base on which the accountant's opinion rested. The past year was marked by the publication of the Commission's report in the matter of McKesson & Robbins, Inc. and by the adoption of substantial changes in the rules as to certificates filed with the Commission. It has been a period of seating the advances and working out their application in diverse situations. While we have promulgated no rules relating to the topics covered by the "Extensions," the accountant who would omit circularization of receivables or physical contact with inventories must now sustain a very heavy burden of proof.

As now drawn, the rules as to certification require the accountant to represent positively that the audit he designed and made was in conformity with generally accepted auditing standards applicable in the circumstances--that is, was at least equal in scope of procedures followed and in the manner of their skillful application to that which his fellow auditors would consider essential in the circumstances. Nor is this as some may fear a leveling down—for each auditor must further represent that no procedure has been omitted which in his own individual judgment should have been employed.

In order that the certificate may be an informative document and not a cloak covering basically dissimilar practices, variations from "normal" are required to be expressly described. This requirement cuts both ways. Omissions of normal procedures must be justified overtly and at once, not many years later when issue is joined in a court proceeding. But what of additional procedures believed necessary by the auditor? As I

see it, disclosure here is as important and under some conditions more so than disclosure of omissions. The average audit is a test and sample procedure, fundamentally justified by the existence of a satisfactory system of internal control. The detailed tests are as much, if not more, a testing of the results of the internal procedures as they are a direct verification of assets, liabilities or income and expense items. To describe an audit in the usual terms when in fact the procedures followed amounted to a detailed audit is to my mind definitely misleading. This is not to deny that the customary audit may include detailed procedures in particular areas where normal procedures have disclosed weakness or uncertainty. That is implicit. But where internal control is lacking or unreliable, or where for other reasons it is deemed desirable to extend substantially the scope of the audit those additions ought to be appropriately described.

You will recall that I have indicated that omissions of normal procedures with respect to significant items must be disclosed. This applies even where, in the opinion of the accountant, special circumstances make the particular procedure, such as circularization of receivables, impracticable or unreasonable. For, unless this is done, no one may know or review the reasonableness of the departure from normal procedure and the way is open for a gradual, idiosyncratic and almost subterranean enlargement of the areas in which so-called "normal procedures" are not operative. As yet the new procedures have by no means been fully integrated with the remainder of the audit program. Their introduction may permit reductions in work of other categories as is evidenced by some cases that have been brought to my attention. Their employment may result in discoveries that lead to additional work. If experience leads to common agreement as to circumstances justifying omission, appropriate institutional and public recognition thereof seems the proper procedure.

These requirements as to observation of normal procedures do not in any way lessen the need for sound professional judgment on the part of the auditor. If nothing else, a sound answer to the problem of whether to go further than usual calls for the highest order of judgment and initiative. After all, normal procedure is a skeletal affair which assumes form and meaning at the hands of the auditor. Even if one must class accounting as an art, as has been suggested by certain bulletins of the Institute, one must at the same time admit that the artist is somewhat limited as to the number of hands and feet, eyes and ears with which he may equip his subject.

There remains the question of delegation of work to subordinates. Primary, of course, is the principle that one can delegate performance but not responsibility. Moreover, it would seem contrary to the spirit of the requirements for certification by independent public accountants to have the certificate bear the signature of an individual or firm when, in fact, the individual or the responsible member of the firm had taken no part in the engagement other than perhaps to exercise due care in the employment of subordinates. Until a firm is willing to clothe an individual with the duties, responsibilities and rewards of membership, it would seem to me that he should not be considered to be qualified to bear the sole or final responsibility for deciding the complex and varied problems that arise in determining the scope of the audit and for judgment the integrity and clarity of the financial statements themselves. The views of the

Commission on this question are summarized in its opinion in the Interstate Hosiery case and need not be repeated here.

One final event in this field is worthy of mention--the passage of the Investment Company Act of 1940 with its provisions as to accountants and auditors. Under its provisions, auditors are to be selected by a majority of the members of the board of directors who are not officers, employees, affiliates, or investment advisers of the trust, subject to ratification or rejection at the annual meeting of stockholders. Moreover, the certificate of the accountant is required to be based on an audit not less in scope and procedures followed than that which independent public accounts would ordinarily make for the purpose of presenting comprehensive and dependable financial statements. Thus, statutory recognition is accorded the philosophy that the scope of an audit is not a matter of personal whim but, to be useful in financial and investment decisions, must be such as would pass muster before a jury of reputable auditors.

PROFESSIONAL CONDUCT

In dealing with these three categories of problems it may seem that I have labeled each as the most important. And surely the next group--problems as to professional conduct--is of no less importance. Considering all of the groups together one can perhaps assign to each the exclusive and special importance that would attach to the fourth leg of a four-legged stool.

The ethics of a profession present problems of a quite different order than do its theories and mechanics. They relate to the moral suasions and self-discipline which are the inherent badges of a true profession. They are at once the measure of its stature and its safeguard against decay. The concept of independence which has been the object of consideration attention by the Commission is inextricably intertwined with these ethics. While in some aspects independence may be a distinct issue, many types of unethical conduct are at the same time evidence of lack of independence.

As an abstract concept, independence may be succinctly expressed as objectivity or freedom from bias. To list the acts, relations and events which mark its presence or absence is, however, most difficult. It cannot usefully be described as solely a subjective matter--the state of mind with which the accountant seeks to approach his duties--for bias by definition is unconscious. If the accountant is to protect himself from criticism or the innuendo that slight carelessness or choice of a debatable alternative was due to lack of independence, he must first divest himself of such outward affiliations as might lend color to such presumptions. While independence must then be defined in terms of events or relationships, yet, on the other hand, inferences of a personal nature do not necessarily flow from the "undifferentiated application of uniform objective standards" but from all the facts of a given case. Finally, one may not always arrive at a sound conclusion on the question of independence by considering each relevant fact separately, but often only by considering the cumulative force of all the circumstances of a case. This force increases almost by geometric progression so that relationships of small importance, viewed singly, may take on far greater meaning when superimposed on other probative evidence.

During the year the Commission had occasion to study this problem in the light of the facts of the *A. Hollander & Son, Inc.* case.[6] A statement of its conclusions and its views on several important aspects of the problem may be found in the opinion released some months ago.

Mere rules, of course, will never make an accountant objective. Neither is it possible to determine in the abstract all the circumstances that would justify the conclusion of non-independence. Nevertheless, experience and reason clearly point to certain conditions as so likely to impair objectivity as to warrant their peremptory proscription. On this ground there is general agreement that the accountant who is a director, officer, or employee of his client or who has a substantial financial interest in his client may not be considered independent. A recent accounting release, number twenty-two, added the existence of an agreement whereby the accountant is held harmless from all loss or damage flowing from his professional work, unless due to his willful misconduct. To my mind, the same doubts as to independence are created by the existence of a variety of other substantial extra-professional relationships, such as interlendings, joint business ventures with principal officers of a client, and so on. This is by no means to say that the accountant, to maintain his independence, must become a hermit or stylite divested of all social intercourse, but rather that he avoid relationships with a client which may invite suspicion. Rules, and the facts of decided cases serve as warnings, pricking out the borderline that ought never to be reached.

Flagrant violations of generally accepted standards of auditing or accounting, or indeed in some cases of clear-cut rules of the Commission, always invite the conclusion of deliberate misconduct, subservience, or--perhaps at best--woeful incompetence. From the viewpoint of an accountant these, I think, are acts discreditable to his profession. The voluntarily agreed-upon code of ethics or rules of professional conduct--and more particularly the manner and uniformity of their interpretation and application--are matters of great interest since one of their major objectives is to discipline members who have committed such acts. In this field the adoption during the year of revised rules of professional conduct by the Institute and by numerous state associations is of marked importance. For present purposes, the most noteworthy feature is the increased breadth and more explicit language of Rule 5, dealing with representations as to financial statements and their examination. If the tenents of that rule are fairly interpreted and applied without fear or favor, professional conduct will be held at a new high level.

There exists independent of the disciplinary machinery of the professional associations the privilege of an administrative body to regulate practice before it. As expressed in our Rules of Practice, the accountant who by his acts shows himself not to possess the requisite qualifications to represent others, to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct thereby subjects himself to disqualification or to denial, temporarily or permanently, of the privilege of practice before the Commission. Proceedings under these rules are, of

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[6] Securities Exchange Act, Release 2777.

course, quite apart from, and in no way dependent on, the results of previous or concurrent proceedings of professional associations or state administrative bodies.

Most if not all of the progress that has been made in recent years has been partly directed toward the proper solution of a final issue that in many respects cuts across--or perhaps underlies--all of the technical problems I have touched on. It is the question of the accountant's responsibility and consequently of the value of his services.

Accountants have maintained, and the courts have generally recognized, the doctrine that a public accountant's responsibility is measured by the standards that would have been observed by his peers under similar circumstances. At the same time, the strengthening, or indeed the maintenance, of any profession lies not in limiting its responsibilities or in standing pat, but in recognizing and embracing new and proper spheres of responsibility, and consequently of service. Such a doctrine, therefore, is not wholly free from danger since it may engender a complacency that can stifle progress in accepting the new and sometimes heavier responsibilities of an advancing society. Certainly no mere concert of approval by practitioners can long preserve modes of conduct or ways of thinking that society deems unuseful. So, while the standard of conduct for which an auditor or accountant will be held answerable at law may be that which his peers in his profession observe, yet he and his peers are being judged by those who utilize the services offered. Restrict those services unduly and you will find the demand for them vanished. Protection against liability at the sacrifice of business and social utility is a poor choice. The professional man above all must beware, lest, as Judge Healy said, "in winning too many battles he lose the war."[7]

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[7] R.E. Healy, *Next Step in Accounting,* Accounting Review, March, 1938, p. 7.